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# GST ON INTERNET PURCHASES

Is GST adaptable to the Internet?

Lloyd Gallagher

The growth of the internet market place is incredible. Over the past decade there has been an explosion of businesses exposing their commerce to online customers resulting in governments considering options of internet taxation. The arguments have wide ranging legal consequence from administration to enforcement and questions arise as to whether the current tax structure can cope with an imposition of consumption tax, such as Goods and Services Tax (GST), in this emerging commerce environment. Further, if consumption tax is imposed on internet sales what affect will this have on the global market and consumers? This paper will focus on a review of GST in the current New Zealand landscape, in relation to Internet commerce with imports and exports, with a look at the practical issues of imposing consumption tax, from a New Zealand perspective with GST, on internet goods.

### **Background of Income Tax in NZ**

Income Tax in New Zealand is designed on the principle of raising revenue that allows government to execute social and economic objectives.<sup>1</sup> The principles behind taxation is the requirement that all taxes act evenly on all sectors of the community<sup>2</sup> with simplicity and ease of compliance.<sup>3</sup> If tax systems are complex difficulties arise in design and efficiency causing problems with future planning and compliance.<sup>4</sup> This plays a major role on investment into New Zealand and has resulted in legislators designing tax policies that remain consistent with internationally accepted tax practices<sup>5</sup> on the basis that proper tax practice is neutrality and a system that provides clarity for business decisions that allow capital investment with maximum pre tax return.<sup>6</sup> Despite this Governments see it necessary to review imposing a use tax on the internet based purely on the lack of revenue streams. The excuse ranges from revenue streams drying up due to internet commerce to generating increased revenue from internet sales and despite the arguments being raised separately these are clearly the same argument. In New Zealand the Right Honourable Dr Michael Cullen suggests extending GST on all sales made over the internet as a means to curb this loss suggesting that this makes good economic sense.<sup>7</sup> Before we begin to look at the effect a

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<sup>1</sup> Richardson, I.L.M "The Concept of Income and Tax Policy Canterbury Law review" (1990) 4 CLR 203 at [203].

<sup>2</sup> Ibid at [203].

<sup>3</sup> Ibid.

<sup>4</sup> Ibid at [206].

<sup>5</sup> Ibid.

<sup>6</sup> John Isaac "Development of Tax Policy Formulation and Presentation: a Retrospect" (2006) 3 BTR 222 at [224].

<sup>7</sup> Hon Dr Michael Cullen, Hon Paul Swain, John Wright *GST and imported services - a challenge in an electronic commerce environment* (2001).

consumption tax may have it is important I provide a brief overview of the consumption tax in New Zealand known as GST.

### **A brief overview of GST in NZ**

GST is imposed in New Zealand on all goods and services that are supplied in New Zealand by any person. A person being defined in s 2 of the Goods and Services Tax Act 1985 (GST Act) as including by definition a person, company, unincorporated body of persons, public authority and local authority. In this way all businesses of any type shape or form, including but not limited to a person undertaking purchases of regularity, are included in the liability for GST. This includes any transaction made over a website as a website selling goods or services does not act independently of its owner. In 2002 the Inland revenue Department released a guide book called Guide to tax consequences of trading over the internet (GTCTI),<sup>8</sup> which is still current today despite the need for the tax rate to be changed. The GTCTI reinforces that all sales sold over the internet in New Zealand will attract GST regardless of their size.<sup>9</sup> However, as I will discuss later internet services are an exemption to the rule.

Services are defined in s 2 as anything that is not goods or money and goods are defined as all kinds of personal or real property, excluding choses in action.<sup>10</sup> As discussed above the GST Act requires a level of regularity due to the requirement of the supplier being engaged in a Taxable activity which is defined in s 6 of the GST Act. To be a taxable activity the activity must be continuous or regular in nature, regardless of any pecuniary profit, and covers all types of supply to any other person for consideration.<sup>11</sup> Consideration is broadly defined within s 2 as including any payment, act of forbearance - voluntary or otherwise resulting in any traded item being subject to GST. However, it expressly excludes unconditional gifts to a non profit body. This means that any supply of goods and/or services in New Zealand with an annual turnover of \$60,000 New Zealand dollars must be registered, or will be deemed registered,<sup>12</sup> and required to pay GST on all but zero rated and exempt supplies of goods and services regardless of how they are derived even if over the internet.<sup>13</sup>

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<sup>8</sup> Commissioner "Guide to tax consequences of trading over the internet" (2002) Inland Revenue <<http://www.ird.govt.nz/forms-guides/number/forms-unnumbered/guide-tax-trading-internet-pdf.html>>.

<sup>9</sup> Ibid, at ch 3.

<sup>10</sup> Goods and Services Tax Act 1985, s 2.

<sup>11</sup> Ibid, s 6(1)(a).

<sup>12</sup> Ibid, s 51(4)(b).

<sup>13</sup> Ibid, s 8(1).

As will be discussed later even a private person may fall liable to GST on items purchased over the internet regardless of the registration requirements due to customs and excise law. However, before any person becomes liable for taxation of any kind that person must be a resident of the country to where the sale took place.<sup>14</sup> This is important due to double tax agreements, discussed later, preventing imposition of tax liability on consumers in two separate countries in effect creating double tax. Accordingly, a review of how residency is decided is important before I continue.

### *Residence of the natural person*

Residency is based on the principle of where a person permanently lives. This, however, is not as easy as it sounds due to the complications of business travellers being in foreign countries for long periods of time or having their living location separate to their business locations to protect against foreign tax. Accordingly, legislators have setup a set of rules accepted internationally to determine the issue. The GST Act does this by referring back to the Income Tax Act 2007 (ITA) which pursuant to s YD1 the residence of a natural person is determined by whether or not that person has a permanent place of abode in New Zealand. If the person has a permanent place of abode, regardless of whether they physically live there or not, they will be a tax resident.<sup>15</sup> Further, if the person does not have a permanent place of abode but is personally present in New Zealand for more than 183 days in a 12 month period regardless of the location of their permanent place of abode,<sup>16</sup> and if they are not personally absent from New Zealand for 325 days in a 12 month period,<sup>17</sup> the person will be a New Zealand tax resident and liable for New Zealand taxes. This was discussed in *Case U17*<sup>18</sup> where the Court held, discussing s 241 of the Income Tax Act 1976 the predecessor of s YD1 of the ITA, that residency was to be determined by the location of the permanent place of abode that a tax payer had with regard to the 183 and 325 day rules.<sup>19</sup> Therefore, any person will be a tax resident if they either a) have a permanent place of abode in New Zealand; or b) are present in New Zealand for an aggregate 183 days in any 12 month period.

### *Residence of a company*

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<sup>14</sup> *De Beers Consolidated Mines Limited v Howe (surveyor of taxes)* [1906] AC 455 (HL).

<sup>15</sup> Income Tax Act 2007, s YD1(2).

<sup>16</sup> *Ibid*, s YD1(3).

<sup>17</sup> *Ibid*, s YD1(5).

<sup>18</sup> *Case U17* (1999) 19 NZTC 9,174.

<sup>19</sup> *Ibid*, at [9,179].

Section YD2 of the ITA provides that a company is resident for tax purposes if it is incorporated in New Zealand, or if its head office is in New Zealand, or if its centre of management is in New Zealand, or if its directors in their capacity as such exercise control of the company from New Zealand.<sup>20</sup> The 183 day rule is modified for companies in that a company ceases to be a resident immediately on becoming a foreign company unless s YD2(1) applies being that the management remains in New Zealand within the 183 day rule of its foreign company status being declared.<sup>21</sup> The principle of Company residence goes back as far as 1906 and derives its interpretation from the case of *De Beers Consolidated Mines Limited v Howe (surveyor of taxes)*,<sup>22</sup> where the House of Lords held that: a company resides for the purpose of income tax where its real business is carried on,<sup>23</sup> business being argued as the undertaking of management to exercise their authority in day to day tasks. New Zealand reaffirmed this position in 1995 in the case of *NZ Forest Products Finance NV v CIR*.<sup>24</sup> Therefore, a company will be resident for New Zealand tax purposes if it carries on business from New Zealand's domain.

### **Application of the GST landscape - New Zealand and Exports**

Section 8(1) of the GST Act states that GST is chargeable on goods and services if supply is made in New Zealand and is not an exempt supply pursuant to s 14. Section 14 supplies relate to dwelling houses and financial services which are not important for the scope of this paper. Prima facie, if supplies are outside New Zealand then they will not attract GST. Section 2 of the GST Act refers to s YA1 of the ITA for the territory of New Zealand which states that the territory of New Zealand includes the continental shelf,<sup>25</sup> as defined by the Continental Shelf Act 1964 and the water and air space above any part of that continental shelf that is beyond New Zealand's territorial sea as defined by s 3 of the Territorial Sea, Contiguous Zone, and Exclusive Economic Zone Act 1977. Accordingly, any supply as defined by s 5(1) of the GST Act as "all forms of supply", excluding layby sales, door to door sales, government levies and a general exception to Court awards,<sup>26</sup> will result in GST liability. Further, any goods and services supplied across the internet that fall within the

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<sup>20</sup> Income Tax Act 2007, s YD2(1).

<sup>21</sup> *Ibid*, s YD2(2)

<sup>22</sup> *De Beers Consolidated Mines Limited v Howe (surveyor of taxes)* [1906] AC 455 (HL).

<sup>23</sup> *Ibid*, at [458].

<sup>24</sup> *NZ Forest Products Finance NV v CIR* (1995) 17 NZTC 12,073, at [12,081].

<sup>25</sup> Income Tax Act 2007, s YA1 New Zealand - (a).

<sup>26</sup> See further the expansion of supply under the Goods and Services Tax Act 1985, s 8.

continental shelf attract GST the same as physical shop purchases.<sup>27</sup> However, anything outside New Zealand's territory will be exempt and zero rated under s 11(1) of the GST Act due to their export nature. For example if a New Zealand person is located in New Zealand, as defined by the residency provisions under s YD1 (Personal residence) of the ITA, GST liability will arise only on sales to New Zealand Customers.<sup>28</sup> Where a company is resident, pursuant to s YD2 (company residence) of the ITA, and provides services undertaken by New Zealand residents then both GST and Income Tax liability applies regardless of the server's location, website location, or product location.<sup>29</sup> In summary, the minute the transaction is invoiced and supplied by a New Zealand resident to a New Zealand resident GST and Income Tax apply. Where the supply is not in New Zealand then it is an export and zero rated for GST. However, this same export will attract Income Tax liability pursuant to s YA1 of the ITA.

### **Application of Double Tax arrangements, Income Tax and GST landscape - New Zealand and imports**

There are two separate issues with the taxation, both on income tax and GST, on imported goods from the internet. The first relates to Double Tax Agreements (DTA) the second with responsibilities of customs and excise. The first issue, that of the DTA, arises from agreements with foreign countries designed to increase investment by not penalising suppliers twice for the same supply. Where New Zealand has organised a DTA, as New Zealand has with Australia, any person, as defined by s 2 of the GST Act, resident in Australia and hosting a business website in New Zealand that sells to a New Zealand resident, will not pay GST in New Zealand.<sup>30</sup> However, there is a caveat to this as liability for GST may be imposed if the goods are shipped cost-insurance-freight (CIF). This can be illustrated as follows: a non-resident who is exporting goods to New Zealand ships on a CIF basis and invoices prior to delivery leaving the non-resident responsible to clear the goods through

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<sup>27</sup> Commissioner "E-Commerce and GST" (2010) Inland Revenue < <http://www.ird.govt.nz/ecommerce-tax/ecommerce-gst/business-australian-ecommerce-gst.html>>.

<sup>28</sup> Commissioner "E-Commerce and GST - When are services zero rated?" (2010) Inland Revenue < <http://www.ird.govt.nz/ecommerce-tax/ecommerce-gst/business-australian-ecommerce-gst.html>>.

<sup>29</sup> Commissioner "E-Commerce and GST: Example A" (2007) Inland Revenue <<http://www.ird.govt.nz/ecommerce-tax/ecommerce-incometax/incometax-bus-model-a.html>>; Commissioner "E-Commerce and GST: Example B" (2007) Inland Revenue <<http://www.ird.govt.nz/ecommerce-tax/ecommerce-incometax/incometax-bus-model-b.html>>; Commissioner "E-Commerce and GST: Example C" (2007) Inland Revenue <<http://www.ird.govt.nz/ecommerce-tax/ecommerce-incometax/incometax-bus-model-c.html>>.

<sup>30</sup> Commissioner "E-Commerce and GST: Example D" (2007) Inland Revenue <<http://www.ird.govt.nz/ecommerce-tax/ecommerce-incometax/incometax-bus-model-d.html>>.

customs and arrange delivery to the customer. In this case, the non-resident will incur GST in relation to the importation of the goods charged via New Zealand Customs due to the provisions of s 12 of the GST Act, this is known as the reverse charge.<sup>31</sup> and is levied pursuant to s 12(1) which requires customs to levy GST against the goods as determined by their value under the provisions of schedule two of the Customs and Excise Act 1996 (CE). This is the same for Free on board (FOB) items with the exception that the receiver holds the liability for the GST rather than the supplier. This is what sees consumers being levied for GST on internet imports as I will continue with later. Here the timing of the invoice becomes the pivotal provision and perhaps the saving grace. This is because the supply of goods is made by a non-resident and is considered prima facie evidence that the supply is made outside of New Zealand. As the invoice is raised at a time at which the goods are also physically outside New Zealand the supply cannot be a taxable supply under the Act and therefore, becomes zero rated.<sup>32</sup> This means that both the supplier and the supply must be in New Zealand at the time of invoicing to attract GST.

Where consumers are concerned they fall under the second element that of customs and excise which applies to the standard FOB internet purchases which binds both companies and private individuals alike. Under s 39 of the CE all goods entering New Zealand must be reported to customs. Section 60(1) of the CE then requires that the value of the goods be specified pursuant to schedule two and GST be applied on that value pursuant to s 12(1) of the GST Act. The Chief Executive of customs has the authority to levy as required any item in accordance with the value principles set out in s 12(2) of the GST Act and pursuant to schedule two of the CE Act and includes transportation and insurance costs, and as has been held by the Court of Appeal to also include royalties, as part of the valuation.<sup>33</sup> Where goods are only in New Zealand temporarily or scheduled for export the goods will not attract GST.<sup>34</sup> There is no minimum limit as to when customs may impose the GST levy and is purely one of time and resources left to the discretion of the Chief Executive of customs. Inland Revenue warn that all imported goods may be subject to GST regardless of their value<sup>35</sup> despite any statements to the contrary from the media. However, as a policy exercise customs rarely

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<sup>31</sup> Commissioner "Tax Information Bulletin" Vol 16, No 1 (February, 2004) *Inland Revenue* at [32-45].

<sup>32</sup> *Ibid.*

<sup>33</sup> *Collector of Customs v Avon Cosmetics Ltd* CA CA101/99, 9 November 1999.

<sup>34</sup> Goods and Services Tax Act 1985, s 11(1).

<sup>35</sup> Commissioner "Tax Changes - Budget 2010: GST on Imports" (2010) *Inland Revenue* <<http://www.ird.govt.nz/changes/gst/businesses/imports/>>.

apply GST to items less than \$400 dollars in value due to the workload in imposition and recovery.

### **Application to digital downloads**

*Is it a service or goods?*

I have discussed the issues relating to imports of a physical nature and the current regime in place for imposing GST on imported e-commerce goods. However, it is clear that the sections under the CE Act and the GST Act have been designed to cover physical imports, including digital media shipped in physical form such as DVD's, but do not cover digital items that can be downloaded from the internet. This is due to downloads being argued as services not goods. The current definition of goods under s 2 of the GST Act describes goods as real property and as such downloaded software falls back to the wider all encompassing provision of a service as anything that is not goods.<sup>36</sup> This is due to the provision of s 12(1) of the GST Act imposing GST liability on imported goods not services as they have been expressly excluded. If s 12(1) of the GST Act did not exclude services then s 8(1) of the GST Act which imposes a GST levy on digital downloads as well.

*How could it be enforced even if it was?*

However, even if s 12(1) of the GST Act was amended to include services or digital downloads specifically issues over jurisdiction and enforcement arise. This is because a person downloading software from another country pays a non resident company for those goods, that company being liable for their jurisdictions local income taxation. To impose GST on that sale in New Zealand as well would expose suppliers to double taxation resulting in reduced investment and reduced sales into New Zealand. Dr Cullen argues that the alternative is to impose GST on the consumption making the downloader pay GST.<sup>37</sup> This has substantial risk and compliance issues due to an inability to identify transactions, encryption of transactions preventing their detection, collection of GST from millions rather than a few, an inability to determine the exact source and which country should get billed.<sup>38</sup>

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<sup>36</sup> Goods and Services Tax Act 1985, s 2.

<sup>37</sup> Hon Dr Michael Cullen, Hon Paul Swain, John Wright *GST and imported services - a challenge in an electronic commerce environment* (2001).

<sup>38</sup> Greg Fitzgerald "The GST and Electronic Commerce in Australia" (1999) E Law Murdoch University Electronic Journal of Law <<http://www.murdoch.edu.au/elaw/issues/v6n3/fitzgerald63nf.html>>.



The inability to identify a transaction stems not from the issues of anonymity. As users have an ability to appear anonymous tracking the transaction becomes near to impossible.<sup>39</sup> It is suggested that taxing credit card companies would provide the solution due to verifications being required when purchasing over the internet that confirm the address of the card holder.<sup>40</sup> However, release of this information would require considerable cooperation from international jurisdictions and would result in considerable compliance costs which would be passed onto consumers resulting in less trade. Further, if GST is imposed on consumers the voluntary compliance regime of taxation would require all purchased content downloaded from the internet to be declared resulting in increased costs of administration. It is also unlikely that parents or minors would even realise that some purchases made required declaration due to a lack of understanding of the tax laws. Most consumers using their bank combined eftpos/visa card may often think the purchase from an international source is local due to the way in which a business may present. Further, consumers may make a small purchase, or a repeat purchase not realising that each one had to be declared which would require administration to check each bank account of millions of residents of every transaction. This provides privacy issues not to mention costs in administration.

In addition media campaigns to educate the public would require substantial funding and ongoing release so that everyone entering the country via immigration was also aware of the requirements. There is also the issue of when does a minor become a tax responsible citizen. Under the current system New Zealand does not require registration of a minor for an IRD number until that minor earns an income.<sup>41</sup> This would have to change with every child born requiring compulsory registration and declaring purchases as they made them on their visa/eftpos cards as soon as they had a bank account. This would see costs skyrocket for compliance and would result in an overly complex tax system that will have serious consequences on investment and economic growth. Let's turn to the United States (US) for a look at how this system may work.

## **A US Example**

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<sup>39</sup> Austin Goolsbee and Jonathan Zittrain "Evaluating the Costs and benefits of Taxing Internet Commerce" (Berkman Center for Internet & Society at Harvard Law School, 1999), at [16] <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=175666](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=175666)>.

<sup>40</sup> Ibid.

<sup>41</sup> Commissioner "IRD Number Applications" (2009) Inland Revenue <<http://www.ird.govt.nz/how-to/irdnumbers/>>.

In the US where a person purchases an item within his or her state, as with New Zealand, the purchaser pays a local sales tax.<sup>42</sup> Where that same person purchases out of state the purchase can be likened to New Zealand purchasing over the internet as each state imposes its own consumption tax. In this scenario the purchaser purchases from an outside state and the local state would impose a use tax<sup>43</sup> similar to the reverse charge discussed above, however, unlike the reverse charge the use tax deals with the consumer directly rather than via a business to business two step. This imposed use tax is levied on the consumer directly via self assessment, as would be the case in Dr Cullen's scenario of GST on e-commerce,<sup>44</sup> and the jurisdictional controls set by the Federal Court.<sup>45</sup> In this situation the consumer would declare their purchases and pay the local state levy as required. However, McLaughlin argues that it does not work seeing few consumers comply with the law often due to a lack of awareness.<sup>46</sup> Further, this system is easily avoided as purchases are not tracked out of state through lack of border controls resulting in few sales becoming recorded.<sup>47</sup>

Further issues arose regarding internet taxation and interstate levy resulting in the United States Congress passing the Internet Tax Freedom Act 1998, signed into law by the then President Bill Clinton,<sup>48</sup> with the purpose of promoting and protecting the commercial, educational and information potential of the internet.<sup>49</sup> Zoller outlines that the Act has now obtained its seventh extension and prohibits what the US considers multiple and discriminatory taxes on electronic commerce.<sup>50</sup> The United States has taken a hard line approach with internet and e-commerce use tax outlining that it is bad for competition in a free market and seeks to protect the e-commerce environment of the internet as it allows small and big business to compete equally.<sup>51</sup> The result has seen a surge in income revenue due to an increase of 19.4 million non employer businesses that run from home and use the internet as their advertising and sales medium. During 2003-2004 a growth rate of 4.7 percent

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<sup>42</sup> Matthew McLaughlin "The Internet Tax Freedom Act: Congress Takes a Byte Out of the Net" (1999) 48 Cath. U. L. Rev. 209 at [209].

<sup>43</sup> Ibid.

<sup>44</sup> Hon Dr Michael Cullen, Hon Paul Swain, John Wright *GST and imported services - a challenge in an electronic commerce environment* (2001), at [9.9], [9.12], and [9.19].

<sup>45</sup> Matthew McLaughlin "The Internet Tax Freedom Act: Congress Takes a Byte Out of the Net" (1999) 48 Cath. U. L. Rev. 209, at [210].

<sup>46</sup> Ibid, at [211].

<sup>47</sup> Ibid.

<sup>48</sup> Ibid, at [212].

<sup>49</sup> Martha Zoller "Taxing the Internet and Other Games" (2007) Human Events <<http://www.humanevents.com/article.php?id=23392>>.

<sup>50</sup> Ibid.

<sup>51</sup> Ibid.

was seen producing an annual turnover of \$887 billion US dollars.<sup>52</sup> Among the fastest growing businesses were electronic shopping and mail order houses which included internet based consumer trade at 12.7 percent.<sup>53</sup> This provides a substantial income into the Federal Reserve via income tax revenue and provides an important argument to the positive aspects of maintaining a GST free internet.

### **Income Tax: a better solution**

The US example shows the advantages of consumption tax free internet commerce for government revenue. As retailers, internet based or shop based, must account for their income within their local country of residence governments income streams are maintained and protected through local jurisdiction. In New Zealand internet sales would still be income under the Income Tax Act 2007 and compliance is maintained through the companies' end of year filing with no additional administration costs. The Government maintains its authority to leverage tax without causing political loss through the non neutral position that reverses charges and free imports creates. As the markets are equal to all business the revenue generation is likely to increase generating far more revenue than that created by imposed GST.

### **Conclusion**

E-Tax poses both threats and opportunities to Government revenue. The opportunities come from increased revenue generation while the threats relate to issues of compliance and administration. Under s YD2 of the ITA companies trading via the internet, and have their business in New Zealand, will be subject to Income Tax providing increased revenue to the tax net while the imposition of GST on the internet seeks to increase compliance and education costs. Imposing GST on the internet is likely to shadow and stall economic growth and prevent investment due to over complication of compliance with tax law. It is submitted that keeping the internet GST free provides greater tax revenue by encouraging more business and economic growth to New Zealand.

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<sup>52</sup> US Census Bureau "Nonemployer Statistics: 2004" (2006) U.S. Department of Commerce at [1] <<http://www.census.gov/prod/2006pubs/ns0400a01.pdf>>.

<sup>53</sup> Ibid.

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### **About the Author**

Lloyd Gallagher the founder of Gallagher & Co has had 18+ years experience in LAW and developing business solutions from IT and Marketing through to events and Project management.

In his early years Lloyd trained as a telecommunications technician in while working for Telecom then branched out into his own IT company now known throughout New Zealand and Australia as LG Holdings. Lloyd was instrumental in developing the first ISP and ADSL solutions for New Zealand, and has been featured in the Best of the Best 2 years running and countless computerworld magazines.

Lloyd has qualifications in Business Management and is a practicing Tax Agent for Inland Revenue in New Zealand.

Lloyd completed his four year degree in management in 2.5 years and his Bachelor of Laws in 3 years. Lloyd now embarks on a Masters in Law (LLM) and a Masters in Management Communications (MMS). Lloyd will then move to complete the degree with a Doctorate.

Adding to his credentials Lloyd has guest lectured at M.I.T (Manukau Institute of Technology) a prestigious Institute in Auckland. Through his involvement the Lecturers offered him a place on the advisory committee helping students to prepare for the real world.